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SUBJECT: Economic and financial leaders debate Egypt's economic future

Sensitive but unclassified. Please handle accordingly.

1.(SBU) Summary: The Ambassador invited a diverse group of financial business leaders and economic thinkers to the Residence for an Economic Roundtable to discuss Egypt's current economic situation and its future. The group included the World Bank Resident Representative, two investment bank CEOs, an economics professor from the University of Cairo, and a partner at a leading law firm who is also a former AmCham President. There was considerable agreement about the problems Egypt faces, many of which are well known, but less confidence that the road ahead will be smooth or that the government would cope with the challenges competently. The overall tone showed somewhat more anxiety than similar such conversations just a few months ago, presumably a function of the continued global downturn and the first quarter growth in Egypt (July-September) coming in under expectations at 5.8 percent and Egypt's stock exchange has been one of the hardest hit in the region, losing over 60 percent year-to-date. End Summary.

12. (SBU) There was an unwavering view that the global situation was extremely serious and that it has already begun to affect Egypt. There was also general agreement that compared with many other countries, Egypt's banking system was in better condition than others and that Egypt was entering the crisis from a position of relative strength. This is a result of the banks' conservative history and the Central Bank's supervision which has emphasized stringent availability of credit, over the need to expand credit growth to spur business.

13. (SBU) There was also general agreement that Egypt would feel the effects of the global crisis through reduced FDI, less demand for exports, reduced remittances, and reduced use of the Suez Canal. Participants went on to note that domestic demand would also likely suffer, in part from psychological effects of malaise. The group stated that domestic demand needs to be energized, and they seemed to share the view, expressed by Minister of Finance Boutros Ghali recently, that interest rates are excessive and that reducing interest rates should be one tool the government uses to stimulate demand (Note: urban inflation came in at 20.2% in October, and the benchmark interest rate is 11.5%. End note.) Mohammed Taymour, Chairman of Pharos Holdings, argued that inflation is falling, so if one takes a forward-looking approach, the real interest rate is not as negative as if one looks backward, arguing that rates need to come down to stimulate domestic demand, as is being done in many countries around the world.

14. (SBU) Two other means of stimulating demand suggested by Taymour, were to direct new fiscal spending towards subsidizing mortgages to stimulate the housing market and providing more quality investments in schools. (There is a subsidized mortgage product in Egypt, but it

is only for the poor. Regarding investing in schools, the Finance Ministry has been trying to launch a public-private-partnership program to build 300 schools and we expect its launch imminently. Its impact on jobs, growth, domestic demand, or on the quality of education, will not be known for some time. End note.)

15. (SBU) Taymour noted that the Central Bank's handling of the exchange rate also contributes to Egypt's falling exports. He noted that nearly all currencies of the world have depreciated this year against the dollar, yet the pound remains at or near the same rate the year began. He argued it should be allowed to float more freely and that Egyptians should not be so psychologically concerned about the pound reaching 6 LE/\$1 (Note: the pound currently trades at 5.56 LE/\$1. The pound has not shown much movement since the CBE adopted the current "managed float", but this summer the pound did show some strength, appreciating to 5.25 LE/\$1 in August, before depreciating towards its more historical trading band where it stands now. End note.) Alla Saba, from Beltone Financial who also sits on the Central Bank Board of Governors, noted that the Central Bank is not trying to peg the rate, but rather, wants to limit extreme volatility. Saba warned that if the pound were to depreciate beyond 6 LE/\$1 it could result in greater dollarization.

16. (SBU) Regarding the labor force, the group noted that the government has been focused on job creation in the last several years, setting a target of creating 750,000 jobs a year just to barely keep ahead of new job entrants. This effort has shown some results in the official data as unemployment figures have edged down from 11% to 8% in the last several years. All noted that the big firms in Egypt have been in a hiring mode for the past several years. However, speaking from real experience, some in the group noted that not only were firms slowing down new hires, there were some who were considering layoffs. As a means to make Egypt's labor

law more flexible and to make the hiring and firing procedures more responsive to private sector needs, the 2002 Labor Law included a provision which states that firms may release labor when economic conditions merit it. Taher Helmy of Baker MacKenzie noted that the looming downturn will force the first test of that provision, as the economy has been growing steadily since the provision was introduced. The outcome of that test was far from clear, he noted.

17. (SBU) The Roundtable coincided with President Mubarak's annual address to the Parliament, and there was some commentary on Mubarak's remarks. In particular, all agreed that in order to ensure that job creation is maintained, and to provide something useful to the country, there needs to be greater government attention paid to investing in infrastructure that can employ large numbers. The quality of infrastructure in Egypt has been improving, but remains below the quality of regional peers and is one deterrent for more investment. Some speakers decried the large projects, which are the typical Egyptian response, often with large fanfare and large expense but take a long time to materialize and do not have the practical impact needed. They suggest that instead, the government should focus on smaller projects, as simple as paving unpaved roads, adding sidewalks where there are none, etc. Mubarak's speech did refer to infrastructure, but only in general terms, mentioning the need for investment in water, ports and roads.

18. (SBU) As with any discussion on the quality of Egypt's banking sector, there was praise for the banks' conservative positions which makes them less vulnerable in this down turn, along with the accompanying frustration in the banks' consistent lack of interest in actually lending and playing the critical role of stimulating private sector development. (Note: Banks in Egypt make reliable strong returns simply by rolling over government debt, so do not have strong incentives to lend. Banks also tend to stick with their trusted large corporate clients, and have been slow to enter the SME market. This is slowly changing. Egypt also does not have a strong non-bank financial sector geared towards the needs of the poor; microfinance is relegated to NGOs and business associations which are not able to generate the efficiencies of scale needed to make microfinance more successful. End note.) Alia el Mahdi from Cairo University believed that Egypt's banks have failed the Egyptian entrepreneurs and Taher Helmy strongly agreed. Saba agreed that banks had become too risk averse, but urged the group to consider

where the sector has come, noting that the Central Bank has largely ceased to direct banks when and how to lend, but rather, has allowed market principles and credit risk analysis to determine the value of potential new clients. All agreed that access to finance for micro, small and medium customers remained a significant stumbling block to Egypt's successful growth, and that neither the government nor the market were responding quickly enough or efficiently enough to this reality.

19. (SBU) Comment: The group concluded by noting that many reforms considered "low hanging fruit" had been completed, and that now the reform effort was more difficult for the government. They noted that there is little political consensus in the country, and little trust between citizen and state. The instinctive reaction of the public and the media is to assume the worst with any new government initiative, regardless of the economic merits of the reform. The conversation reinforced the need of the government to develop a greater political consensus and to improve its dialogue and messaging with the citizenry. Converting that to a reality will be difficult, so in the meantime, USG efforts to support the reformers as much as possible needs to continue, to set the stage for the day when the government can tackle large structural issues with the support of its populace.
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